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SUBJECT: RUSSIAN STOCK MARKET REPORT 2006

REF: A. SUPPLEMENT TO 9/22/06 ECONOMIC WEEKLY

¶B. MOSCOW 6926

¶1. Since its consolidation in 1996, the Russian stock market has experienced growth that has led emerging markets and rivaled developed markets. Capitalization was close to USD 1 trillion by the end of August, compared to USD 346 billion at the end of August 2005, and USD 177 billion at the end of ¶2003. The Russian Trading System's (RTS) index of 40 common and 10 preferred shares climbed from its 1998 low of 40 to an all-time high of 1,765 in May.

¶2. Natural resource firms have fueled the vast majority of this growth, thanks to a favorable ruble exchange rate following the 1998 crisis and global increases in commodities prices. The participation of foreign and domestic institutional investors is rising, as are market trading volumes and liquidity. Perhaps the most unsung factor accompanying Russia's swelling market valuations has been the trend among established and emerging firms in Russia to raise primary market equity capital at home.

¶3. It is true that Federal Financial Market Service Chief Oleg Vyugin lamented that Russia's capital was "escaping" abroad when as much as 60 percent of trading in Russian stocks occurred on foreign exchanges in the 2003-2004 period. It is also true that, in an effort to regain this capital, the FFMS instituted new rules in February to limit the percentage of new stock issuances that Russian firms can list abroad. Nevertheless, the apparent preference among Russian firms for raising equity domestically had already materialized. The decrease in net capital outflows during 2005 suggests that a portion of the increasing volume of capital remaining in Russia is funding Russian companies (Reftel B). Russian-sourced issuances in 2005 roughly doubled those of 2004. More recently, Vyugin observed during the 10th Annual Renaissance Capital Conference in June that a bullish outlook on the market was justified. He said the reason for optimism centered on results from 2005: growing capitalizations; an increase in household demand for ruble-denominated assets; and an increase in the number of non-resource firms that had completed equity issuances.

¶4. And now the rest of the story. First, market capitalization remains highly concentrated in the energy sector. Gazprom alone claims around 25 percent of total capitalization. The next four largest firms account for another 40 percent. The stock market's fortunes, consequently, have risen and fallen on traders' valuations of these firms. Second, the GOR has approved a Financial Market

Development Strategy to address systemic deficiencies that impede Russia's market competitiveness. A top priority in this regard is the establishment of a central depository that would improve efficiency in settlement activity. Since settlements can take months in some cases, many foreign investors opt to hold depository receipts. Finally, the GOR's control over the shares of listed firms is considerable, although estimates vary on just how much market capitalization that is.

¶5. The Russian stock market, unlike the NYSE or the LSE, is not driven by the "small, individual investor" whose presence and diversified nature create "sticky stock prices" and more capably copes with financial fluctuations. Although the Director of the Moscow Interbank Currency Exchange (MICEX) Aleksey Rybnikov has reported an increase in Russian investors trading in Russian equities, particularly after the liberalization in trading Gazprom shares last year, recent studies indicate that less than five percent of Russians own stocks or other financial investments. Consequently, the Russian stock market is not yet "creating wealth" among small investors, as has happened in western markets. This will be the next step on its path to becoming a major player in the global trading market.
BURNS